CLERK'S COPY:

TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1940

No. 55

DONALD S. McCLAIN, PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITION FOR CERTIORARI FILED APRIL 15, 1940.

CERTIORARI GRANTED MAY 20, 1940.

SUPREME COURT OF THE UNITED STATES

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COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

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TRANSCRIPT OF RECORD.

UNITED STATES CIRCUIT COURT OF APPEALS,
FIFTH CIRCUIT.

DONALD S. McCLAIN,
Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition to Review the Decision of the United States Board of Tax Appeals.

DOCKET ENTRIES.

Donald S. McClain, Petitioner,
vs. Docket No. 92705.
Commissioner of Internal Revenue, Respondent.

Appearances.

For Petitioner:
M. E. Kilpatrick, Esq.,
Harold Hirsch, Esq.,
Marion Smith, Esq.

1938.

Mar. 25—Petition received and filed. Taxpayer notified. (Fee paid.)
Mar. 25—Copy of petition served on General Counsel.
May 6—Answer filed by General Counsel.
May 6—Request for Circuit hearing in Atlanta, Georgia, filed by General Counsel.
May 16—Notice issued placing proceeding on Atlanta Calendar. Answer and request served.
Dec. 7—Hearing set Feb. 20, 1939, Atlanta, Georgia.

1939.

Feb. 20—Hearing had before Mr. Disney on merits. Submitted. Stipulation of facts filed. Petitioner's brief due 3/10/39—respondent's brief due 4/1/39—reply due 4/10/39.

Mar. 6—Transcript of hearing 2/20/39 filed.

Mar. 10—Brief filed by taxpayer. 3/10/39 copy served.

Apr. 5—Motion for leave to file brief filed by General Counsel—brief lodged. 4/6/39 granted.

Apr. 13—Reply brief filed by taxpayer. 4/13/39 copy served.

June 22—Supplemental brief lodged by taxpayer.

June 28—Motion for leave to file supplemental brief filed by taxpayer. 6/29/39 granted.

June 30—Copy of motion and brief served on General Counsel.

Aug. 30—Memorandum opinion rendered—John E. Murdock, Division 3. Decision will be entered for the respondent.

Sept. 5—Decision entered—J. E. Murdock, Division 3.

Nov. 18—Supersedeas bond in the amount of $2,068.50 approved and ordered filed.

Nov. 18—Petition for review by U. S. Circuit Court of Appeals, Fifth Circuit, with assignments of error filed by taxpayer.

Nov. 24—Proof of service filed by taxpayer.

Nov. 18—Praecipe for record filed by taxpayer.

Nov. 24—Proof of service of praecipe filed.

2 PETITION.

Received Mar. 25, 1938.

Filed Mar. 25, 1938.

(Title Omitted.)

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (Bureau Symbols IT:C:2-CLW-90D) dated February 16, 1938, and as a basis of his proceeding alleges as follows:

1.

Petitioner is an individual, with residence at 20 Cherokee Road, (outside City) Atlanta, Georgia.

2.

The notice of deficiency, a copy of which is hereto attached as a part hereof and marked "Exhibit A," was mailed to petitioner on February 16, 1938.

3.

The taxes in controversy are income taxes for the year 1935. The entire deficiency of $1,034.25 deter-
3 mined by the respondent is in controversy.

4.

The determination of tax set forth in the said notice of deficiency is based upon the following errors hereby assigned to the determination of the respondent:

(a) In determining that $15,000 face value of bonds of Cameron County Water Improvement District Number Two, Cameron County, Texas, owned by petitioner, were retired in 1935.

(b) In disallowing the bad debt of $7,523.25 claimed by petitioner as a deduction in his return for the year 1935, and being on account of determination in said year by petitioner of uncollectibility to the extent of $7,523.25 on $15,000 of bonds of Cameron County Water Improvement District Number Two, Cameron County, Texas.

(c) In limiting to 30% by application of Section 117 (f) of the Revenue Act of 1934, the deduction of $7,523.25, representing a bad debt in connection with ownership of said bonds aforesaid, and in failing to deduct any portion of $7,523.25 in the computation of deficiency.

4 (d) In determining that Section 117 (f) of the Revenue Act of 1934 was applicable, and in applying said section to the bad debt of $7,523.25 determined by petitioner in 1935, and in failing to allow any deduction by reason thereof in the computation of the deficiency.

(e) In increasing the taxable net income of petitioner by $7,523.25 by disallowance of bad debt of said amount.

(f) In determining a deficiency of $1,034.25 for said year.

(g) In disallowing compensation of $661.20 paid the Bankers Trust Company, a trustee, who managed properties of petitioner during the year 1935, said compensation representing necessary expense in the preservation of said

properties and the collection of the income therefrom during 1935.

5.

The facts upon which petitioner relies as the basis of this proceeding are as follows:

(a) As determined by the Commissioner in the ninety-day letter aforesaid, petitioner received as a gift $15,000 par value of Cameron County Water Improvement District Number Two, Cameron County, Texas, bonds in 1918, at a time when the bonds had a value of $15,000.

5 (b) In 1935, petitioner received $7,476.75 from the Cameron County Water Improvement District Number Two Cameron County, Texas, as a partial payment on said bonds. Just prior to said payment the said District had sought the benefits of the Municipal Bankruptcy Act of Congress, whereupon the Act was declared unconstitutional by the Supreme Court of the United State. Thereupon, the said District made application for a refunding loan from the Reconstruction Finance Corporation, which was granted in an amount sufficient to enable the District to pay 49.9¢ on the dollar on the bonds held by petitioner and others.

(c) On information and belief that said Cameron County Water Improvement District Number Two, Cameron County, Texas, at the date of payment in 1935 of the amount aforesaid, executed to the Reconstruction Finance Corporation a mortgage or loan deed or other conveyance to secure payment of the loan obtained by it from the Reconstruction Finance Corporation.

(d) On information and belief that the Reconstruction Finance Corporation at said time made a survey, or had

a survey made, and determined that the said District could pay only 49.9¢ on the dollar of all of the
6 bonded indebtedness owed by it.

(e) That during the year 1935 conditions in said District were very bad and landowners and taxpayers alike were unable to pay their taxes and the said District was in default on both the principal and interest on said bonds.

(f) That petitioner determined the difference, $7,523.25, between the amount paid to petitioner by the District as aforesaid, namely, 49.9¢ on the dollar, or $7,476.75, and the amount of said bonds, $15,000, as being uncollectible, and this determination was made by petitioner in the year 1935.

(g) That petitioner, on his records, charged off the said bad debt during the year 1935.

(h) The expense of $661.20 paid to Bankers Trust Company was for services of said Company in the management and investment and reinvestment of property of petitioner held by said Trust Company as Trustee. The said expense was a necessary expense for the proper maintenance and preservation of petitioner's property, and likewise was an ordinary and necessary expense in the collection of the income and profits from such property.

7 Wherefore, petitioner prays that the Board may hear this proceeding and determine that there is no deficiency due from petitioner for the year 1935.

M. E. KILPATRICK,
HAROLD HIRSCH &
MARION SMITH,
Counsel for Petitioner.

1045 Hurt Building,
Atlanta, Georgia.

EXHIBIT "A".

Treasury Department,
Washington.

Feb. 16, 1938.

Office of Commissioner of Internal Revenue.

Address Reply to
Commissioner of Internal Revenue,
And Refer to

Mr. Donald S. McClain,
28 Cherokee Road, (Outside city),
Atlanta, Georgia.

Sir:

You are advised that the determination of your income tax liability for the taxable year(s) ended December 31, 1935, discloses a deficiency of $1,034.25 as shown in the statement attached.

In accordance with section 272(a) of the Revenue Act of 1934, notice is hereby given of the deficiency mentioned. Within ninety days (not counting Sunday or a legal holiday in the District of Columbia as the ninetieth day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:C1:P-7. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency and will prevent the accumulation of interest, since the interest period

terminates thirty days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,
GUY T. HELVERING,
Commissioner,
By CHAS. T. RUSSELL,
Deputy Commissioner.

Enclosures:
Statement.
Form 870.

9 STATEMENT.

IT:C:2
CLW-90D.

Mr. Donald S. McClain,
28 Cherokee Road,
(Outside city),
Atlanta, Georgia.

Tax Liability for Taxable Year Ended December 31, 1935.

	Liability	Assessed	Deficiency
Income Tax	$1,507.49	$473.24	$1,034.25

In making this determination of your income tax liability, careful consideration has been given to the internal revenue agent's report dated January 25, 1937; to your protest dated March 22, 1937, and to the statements made at the conference held July 22, 1937, in the office of the internal revenue agent in charge at Atlanta, Georgia, and that held December 16, 1937, in this office.

A copy of this letter and statement has been mailed to your representative, Mr. Martin E. Kilpatrick, 1045 Hurt Building, Atlanta, Georgia, in accordance with the authority contained in the power of attorney executed by you and on file with the Bureau.

Adjustments to Net Income.

Taxable Year Ended December 31, 1935.

Net income as disclosed by return	$14,263.79
Unallowable deductions and additional income:	
(a) Trustee's fees	661.20
(b) Bad debts	7,523.25
Net income adjusted	$22,448.24

Explanation of Adjustments.

(a) This item represents trustee's fees paid in connection with a revocable trust of which you are the sole beneficiary, the income of which is taxable to you and was reported in line 5 of your return.

10 Under article 166(c) of Regulations 86, the deductions allowable to the trust, the income of which is taxable to the grantor, are the same as would have been allowable had there been no trust. This article is amended by Treasury Decision #4629 published in Cumulative Bulletin XV-1, June, 1936, page 140; see section (d) of the decision on page 142, which is to the same effect as section 166(c). Since this trust was established for your personal convenience, the fees paid do not constitute an ordinary and necessary business expense, and are disallowed.

(b) The item $7,523.25 claimed on the return as a bad debt is found to represent the difference between the value of bonds of Cameron County Water Improvement District No. 2, Cameron County, Texas, at the time they were received as a gift from your father in 1918, $15,000.00, and the amount you received upon their retirement in 1935, or $7,476.75. It appears that this corporation was far in arrears in payment of principal and interest on the bonds, and that it attempted to take advantage of the Municipal Bankruptcy Act, but when this act was declared unconstitutional it made application for a refunding loan from the Reconstruction Finance Corporation. After careful consideration the loan was granted in an amount which enabled the corporation to retire its bonds at 49.9 cents on the dollar. You are advised that the Revenue Act of 1934 in providing for limitation of losses to be allowed as a deduction on returns, specifically includes amounts received on retirement of bonds. Section 117(f) of that act reads as follows:

"Retirement of bonds, etc.—For the purposes of this title, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidence of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form shall be considered as amounts received in exchange therefor."

It, therefore, appears that the item can not be treated as a bad debt under the statute, since the portion quoted provides that it shall be treated otherwise. Section 117 applies to sales or exchanges of property, and as indicated in the part quoted, it is not intended to be limited solely to voluntary sales between a willing buyer and a willing seller.

11 A pertinent ruling is found in Income Tax 2986 published in Cumulative Bulletin XV-1, June, 1936, page 136, as follows:

"Where the M Improvement District refunded its bonds prior to maturity with the intention of not reissuing them, losses sustained by the holders thereof are subject to the limitation contained in section 117(a) and (d) of the Revenue Act of 1934, unless the bonds were not held as 'capital assets' as defined in the Act."

Since section 117 also places a $2,000.00 limitation on the amount of losses allowable, and that amount has already been allowed, no further loss may be allowed on this item.

Computation of Tax.

Taxable Year Ended December 31, 1935.

Net income adjusted		$22,148.24
Less:		
Personal exemption	$2,500.00	
Credit for dependents	800.00	3,300.00
Balance (Surtax net income)		$19,148.24
Less:		
Interest on Liberty bonds	1,873.46	
Dividends	7,994.37	
Earned income credit	300.00	10,167.83
Net income subject to normal tax		$ 8,980.41
Normal tax at 4% on $8,980.41		359.22
Surtax on $19,148.24 (amount in excess of $4,000.00)		1,149.27
Total tax		$ 1,508.49

Less:	
Income tax paid at source	1.00
Correct income tax liability	$ 1,507.49
Income tax assessed:	
Original, account #80730	473.24
Deficiency	$ 1,034.25

12 State of Georgia,
County of Fulton.

Before me, the undersigned attesting officer, personally appeared Donald S. McClain, who being duly sworn on oath says that he is the petitioner in the within and foregoing petition; that he has read the said petition and that the facts stated therein are true.

DONALD S. McCLAIN.

Sworn to and subscribed before me, the 22 day of March, 1938.

LUCILLE DAY,
Notary Public.

Notary Public, Georgia, State at Large. My Commission expires Sept. 18, 1940.

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13 ANSWER.

Received May 6, 1938.

Filed May 6, 1938.

(Title Omitted.)

Comes now the Commissioner of Internal Revenue, respondent above named, by his attorney, J. P. Wenchel,

Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed by the above-named petitioner, admits and denies as follows:

1. Admits the allegations contained in Paragraph 1 of the petition.

2. Admits the allegations contained in Paragraph 2 of the petition.

3. Admits the allegations contained in Paragraph 3 of the petition.

4(a) to (g), inclusive. Denies that the Commissioner committed errors as alleged in sub-paragraphs (a) to (g), inclusive, of Paragraph 4 of the petition.

5(a). Admits the allegations contained in sub-paragraph (a) of Paragraph 5 of the petition.

(b). Admits that in 1935 the petitioner received $7,476.75 from the Cameron County Water Iimprovement District Number Two, Cameron County, Texas, but alleges that said amount was received in retirement of said bonds and not as partial payment thereon. Admits the remaining allegations contained in sub-paragraph (b) of
14 Paragraph 5 of the petition.

(c) to (h), inclusive. Denies the allegations contained in sub-paragraphs (c) to (h), inclusive, of Paragraph 5 of the petition.

6. Denies generally and specifically each and every allegation in the petition not hereinbefore admitted, qualified, or denied.

Wherefore, it is prayed that the Commissioner's determination be approved and that the petitioner's appeal be denied.

(Signed) J. P. WENCHEL, GWK.
Chief Counsel, Bureau of Internal Revenue.

Of Counsel:
HARRY R. HORROW,
Special Attorney,
Bureau of Internal Revenue.

HRH/vm 5-5-38.

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15 STIPULATION OF AGREED FACTS.

Filed at Hearing Feb. 20, 1939.

(Title Omitted.)

It Is Hereby Stipulated and Agreed by and between the parties hereto, by their respective counsel of record, that the following facts are true and that same may be so taken, and considered by the Board as offered in evidence by the parties to this proceeding; provided, however, that this stipulation shall be without prejudice to the right of either party to introduce other and further evidence not inconsistent with the facts herein stipulated to be taken as true.

1.

The petitioner, Donald S. McClain, a citizen of the United States, residing in Atlanta, Georgia, received, by gift from his father in 1918, $15,000.00 par value of Cameron County

Water Improvement District Number Two, Cameron County, Texas, Bonds, at a time when the bonds had a value of $15,000.00.

2.

Said Cameron County Water Improvement District Number Two, Cameron County, Texas, was and is a political subdivision or branch of the State Government of Texas.

3.

In 1935, the petitioner received from said District on the principal of said bonds the sum of $7,476.75, this amount being made under the following circum-
16 stances:

(a) Just prior to said payment the said District, being unable to pay the interest or principal of its bonds, had sought the benefits of the Municipal Bankruptcy Act of Congress, whereupon the Act was declared unconstitutional by the Supreme Court of the United States. Thereupon, the said District made application to the Reconstruction Finance Corporation for a refunding loan, which the Reconstruction Finance Corporation granted in an amount sufficient to enable the District to pay 49.9¢ per dollar on the principal of the bonds held by petitioner and others; that is to say, all Cameron County Water Improvement District Number Two bondholders received 49.9¢ per dollar on the principal of its bonds from the proceeds of the loan obtained by said District from the Reconstruction Finance Corporation.

(b) At the time that the loan was obtained by the said District from the Reconstruction Finance Corporation in 1935 conditions had become very bad in Texas, land owners or taxpayers in said District being unable to pay their

taxes and the District was in default on both the principal and interest on its bonds, including the bonds held by petitioner. The Reconstruction Finance Corporation made a survey in 1935 just prior to the making of the loan and determined that 49.9¢ on the dollar of the principal was the maximum amount the taxpayer could stand, in addition to current liabilities and charges, and conse-
17 quently that was the extent of the loan made by the Reconstruction Finance Corporation.

(c) Upon making of application to the Reconstruction Finance Corporation by the District, the Corporation sent an appraiser to Cameron County, Texas, who examined the property in the District and the financial condition of the District and of the taxpayers in the District. The application to the Reconstruction Finance Corporation by the District was for a loan of $300,000.00, but after the appraisal aforesaid the Reconstruction Finance Corporation Board passed a resolution on January 6, 1935, authorizing a loan secured by the assets of the District not to exceed $264,500.00 to the District. In authorizing the loan, the Reconstruction Finance Corporation imposed the following conditions:

"*Deposit of Old Securities.* The holders of Old Securities who join in this plan of refinancing shall deposit the same with one or more committees, depositaries, or other responsible representatives satisfactory to them, which shall consent to the plan of refinancing contemplated by this resolution (hereinafter referred to as 'Owners' Agents'), or shall otherwise give this Corporation satisfactory assurances that the Old Securities held by them will be subjected to such plan, in which latter case they are hereinafter referred to as 'consenting owners.' Old Securities deposited with Owners' Agents or held by consenting owners are hereinafter referred to as 'Deposited Securities.' Each Owners' Agent shall be duly authorized to receive

all moneys payable to the holders of Old Securities deposited with it, to surrender the Deposited Securities and do all other acts and things necessary to enable the
18 District to effect a reduction in its indebtedness to the extent and in the manner contemplated by this resolution.

"No loan shall be made hereunder (a) unless all of the Old Securities shall be thus deposited or (b) unless the Division Chief shall deem that such a large proportion of such securities has been deposited as will satisfactorily accomplish the purposes of this Corporation in authorizing this loan. In this latter event, as hereinafter more fully provided, lesser amounts may be payable on the Deposited Securities than in case all of the Old Securities are deposited."

(d) As a result of its appraisal in 1935 the Reconstruction Finance Corporation determined that the said District was then unable to pay the full indebtedness as represented by the bonds held by petitioner and others, and that the extent of the ability of said District to pay its bonds was limited to the said amount which the Reconstruction Finance Corporation lent to said District. In fact, said District in 1935 became financially unable to pay the principal or interest on its bonds except to the extent of 49.9¢ on the dollar of the principal of its bonds.

(e) The bonds of face value $15,000.00 held for profit but not in connection with his trade or business by the petitioner, who consented to the plan of refinancing, were forwarded to a bank in Texas, and upon receipt of 49.9¢ on the dollar the said bonds were delivered over to the bank as agent for the District to be canceled.

19 (f) It was the understanding of petitioner and all other bondholders in so surrendering their

bonds that the amount of 49.9¢ on the dollar so received on account of the principal was the final and only amount which he would receive on the said bonds, although there was no writing to evidence this nor any agreement between the District and the bondholders to that effect.

4.

On his books during the year 1935, the petitioner wrote off as uncollectible the difference between $15,000.00, the value of the bonds at the date of gift to him, and the amount received from the District, namely, $7,476.75, the difference being $7,523.25, which difference petitioner in 1935 determined was uncollectible, and on his income tax return for 1935 petitioner took as a deduction this amount of $7,523.25 as a bed debt.

5.

The respondent determined that the amount received by the petitioner from the District as aforesaid during 1935 constituted a retirement of the bonds and, under the provisions of Section 117 of the Revenue Act of 1934, the respondent limited the said loss of $7,523.25 to $2,000.00. The taxes involved are income taxes for the calendar year 1935 in the amount of $1,034.25.

6.

During the year 1935, petitioner paid to the Bankers Trust Company for services of said company in the management, investment and reinvestment of property held by said Trust Company as Trustee for petitioner, the sum of $616.20. The said payment was made in accordance with the provisions of the trust instrument creating the Trust based upon a percentage of the net income of the Trust. The Trust in question is a

revocable one of which the petitioner is both the grantor and the sole beneficiary. The income from the Trust is taxable to the petitioner and was so reported on his 1935 tax return. The duties of the Trust Company as Trustee under the said deed of trust included the complete management of the trust property, the trust instrument giving the Trust Company full power to manage, invest and reinvest and to convert the property. The Trust Company held all of the securities and made all collections of income and exercised full discretion with reference to matters of investment.

(Sgd.) M. E. KILPATRICK,
Attorney for Petitioner.

(Sgd.) J. P. WENCHEL, SLY.
Chief Counsel, Bureau of Internal Revenue, Attorney for Respondent.

SBA.
WAS-afh 8-31-38.

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21 MEMORANDUM OPINION.

United States Board of Tax Appeals.

Donald S. McClain, Petitioner,
vs. Docket No. 92705.
Commissioner of Internal Revenue, Respondent.

M. E. Kilpatrick, Esq., for the petitioner.

Stanley B. Anderson, Esq., for the respondent.

MURDOCK:

The Commissioner determined a deficiency of $1034.25 in the petitioner's income tax for 1935. Two issues are

presented for decision, first, whether the petitioner's loss from an investment in bonds was a bad debt or a capital loss, and, second, whether he is entitled to a deduction for a fee paid to the trustee of a revocable trust. The facts are found as stipulated.

The petitioner acquired some Water Improvement District bonds in 1918 which had a basis to him for gain or loss of $15,000. The District was unable to pay the interest and principal on its bonds in 1935 and applied to the Reconstruction Finance Corporation for a loan. The loan was granted in an amount sufficient to enable the District to pay $.499 per dollar upon its bonds and upon condition that all or a sufficient amount of the bonds would be deposited and committed to the plan of refinancing the District. The petitioner deposited his bonds, the plan was carried out, and the petitioner received $7,476.75 in cancellation of his bonds in 1935. That was the entire amount which he was entitled to receive. The record does not show what became of the difference of $8.25. The petitioner charged off the balance of his basis as a bad debt and claimed the amount as a bad debt deduction upon his return for 1935. The Commissioner, in determining the deficiency, held that the surrender of the bonds constituted a retirement thereof within section 117(f) of the Revenue Act of 1934 and limited the deduction from the loss to $2,000 under section 117(d).

22

The Commissioner was right. See *S. C. Thompson*, 40 B. T. A. 60, where the Board considered this same question and decided it adversely to the contention of this particular taxpayer. See also *Austin Corbin, 2nd*, 39 B. T. A. 1163.

The petitioner paid $616.20 in 1935 to a bank for its services as trustee in managing, investing and reinvesting the corpus of a revocable trust established by the petitioner and of which he is the sole beneficiary. The fee was paid in accordance with the deed of trust. The income of the trust is taxable to and was reported by the

petitioner. The bank exercised complete control in managing the fund.

The petitioner claims that he is entitled to de-
23 duct the $616.20 upon the facts stipulated. His argument is that he is engaged in the trade or business of managing his own estate and, had he not paid the fee to the trustee, he would have incurred expenses of "bookkeeping, etc." in approximately the same amount. The facts do not show that the petitioner was engaged in any trade or business. Neither do they show that the fee was other than a personal expense of the petitioner paid for his own convenience. It is not deductible under section 23. Cf. *Kane v. Commissioner*, 100 Fed. (2d) 382, affirming 34 B. T. A. 1200.

Decision will be entered for the respondent.

Enter: Entered Aug. 30, 1939.

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24 DECISION.

United States Board of Tax Appeals,
Washington.

Donald S. McClain, Petitioner,
vs. Docket No. 92705.
Commissioner of Internal Revenue, Respondent.

Pursuant to the determination of the Board, as set forth in its Memorandum Opinion entered August 30, 1939, it is Ordered and Decided: That there is a deficiency in income tax for the year 1935 in the amount of $1,034.25.

(Signed) J. E. MURDOCK,
(Seal) Member.

Enter: Entered Sept. 5, 1939.

25 Received Nov. 16, 1939.

Filed Nov. 18, 1939.

(Title Omitted.)

To the Honorable Judges of the United States Circuit Court of Appeals for the Fifth Circuit:

The petitioner in support of his petition filed in pursuance of Section 642, Title 28 of U. S. C. A. petitioning for review of the decision of the United States Board of Tax Appeals rendered on the thirtieth day of August, 1939, wherein the said Board of Tax Appeals approved a deficiency in the income tax of the petitioner in the amount of $1,034.25 for the calendar year 1935, respectfully shows to the Honorable Court as follows:

1. Statement of the Nature of the Controversy.

The controversy herein involved arises by virtue of the Commissioner of Internal Revenue having assessed a deficiency against petitioner in the amount of $1,034.25 for income taxes for the calendar year 1935. The Commissioner of Internal Revenue in determining said
26 deficiency disallowed to the petitioner a deduction claimed by the petitioner in his income tax return for the year 1935 for a bad debt in the amount of $7,476.75. The disputed item arose by virtue of the loss by reason of uncollectibility of Water Improvement District Bonds of the Cameron Water Improvement District No. 2. The said district became financially embarrassed and paid only 49.9 per cent of the face value of its obligations. The remaining 50.1 per cent was determined to be uncollectible and was charged off as a bad debt in 1935. The Commissioner of Internal Revenue determined that the loss suffered by the petitioner was suffered by reason of a retirement of said bonds pursuant to Section 117 (f)

of the Revenue Act of 1934 and limited the deduction of the taxpayer to the amount of $2,000 pursuant to Section 117 (d) of said Revenue Act. The taxpayer's intention was and is that said bonds became uncollectible to the amount of $7,476.75 within the year 1935 and that said amount was properly charged off by him in said year as a bad debt pursuant to Section 23 (k) Revenue Act of 1934.

II. Designation of Court of Review.

The petitioner is aggrieved by said decision of the Board of Tax Appeals herein and seeks a review thereof in accordance with the provisions of the law in such cases pertaining. The United States Circuit Court of Appeals for the Fifth Circuit has jurisdiction on this con-
27 troversy by reason of Section 641 of Title 26 of U. S. C. A. The petitioner is an individual residing within the State of Georgia. He filed his income tax return for the year 1935 in the office of the Collector of Internal Revenue in Atlanta, Georgia.

III. Assignments of Error.

The petitioner as a basis for review makes the following assignments of error:

1. The conclusion of the Board of Tax Appeals that petitioner suffered a capital loss under Section 117 (d) of the Revenue Act of 1934 when he received partial payment on the bonds of the Water Improvement District No. 2, Cameron County, Texas, at the rate of 49.9 per cent is an erroneous conclusion. Petitioner assigns error thereon.

2. The conclusion of the Board of Tax Appeals that the Water Improvement District No. 2, Cameron County, Texas, retired its bonds within the meaning of Section 117 (f) of the Revenue Act of 1934 by making a payment on principal at the rate of 49.9 per cent is an erroneous conclusion. Petitioner assigns error thereon.

3. The conclusion of the Board of Tax Appeals that petitioner was not entitled to a deduction for a bad debt under Section 23 (k) of the Revenue Act of 1934 to the extent that the bonds of Water Improvement District No. 2, Cameron County, Texas, were determined to be worthless and charged off by the petitioner in the year 1935 is an erroneous conclusion. Petitioner assigns error thereon.

4. The action of the Board of Tax Appeals in entering a decision ordering and deciding that there was a deficiency in the income tax of the petitioner for the year 1935 in the amount of $1,034.25 was erroneous. Petitioner assigns error thereon.

Wherefore, your petitioner prays that this Honorable Court may review such findings, decisions and opinion and order and reverse and set aside the same and that the Clerk of the United States Board of Tax Appeals be directed to transmit and deliver to the Clerk of this Court certified copies of all and every document necessary and material to the prosecution and conclusion of the foregoing petition for review and as required by the rules of said Court and statutes made and provided.

HIRSCH, SMITH & KILPATRICK,
M. E. KILPATRICK,
E. D. SMITH, JR.,
Attorneys for Petitioner.

Georgia,
Fulton County.

M. E. Kilpatrick, being duly sworn on oath, says: That he is counsel of record in the above entitled cause; that as such counsel he is authorized to verify the foregoing petition for review; that he has read said petition and is familiar with the statements contained therein and that the statements made are true to the best of his knowledge, information and belief.

M. E. KILPATRICK.

Sworn to and subscribed before me this 14 day of November, 1939.

CAROLINE HANES,
Notary Public.

Received Nov. 24, 1939.

Filed Nov. 24, 1939.

(Title Omitted.)

To J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue:

You are hereby notified that on the 18th day of Nov., 1939, Donald S. McClain, through his attorneys, did file with the Clerk of the United States Board of Tax Appeals of Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Fifth Circuit of the decision of the Board heretofore rendered in the above entitled cause. A copy of the petitioner for review and the assignments of error as filed is attached and served upon you.

This .... day of November, 1939.

HIRSCH, SMITH & KILPATRICK,
M. E. KILPATRICK,
E. D. SMITH, JR.,
Attorneys for Appellant.

Personal service of the foregoing notice, together with a copy of the petition for review and assignments
31 of error mentioned therein is hereby acknowledged.

This 18th day of November, 1939.

J. P. WENCHEL,
Counsel for Respondent.

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32 PRAECIPE.

Received Nov. 16, 1939.

Filed Nov. 18, 1939.

(Title Omitted.)

To the Clerk of the United States Board of Tax Appeals:

You are requested by the petitioner to make a transcript of the record to be filed in the United States Circuit Court of Appeals for the Fifth Circuit pursuant to review taken in the above entitled cause and to include in such transcript of record copies, duly certified as correct, the following documents:

1. The docket entries of proceedings before the Board.

2. All pleadings before the Board.

a. Petition for redetermination.

b. Answer of Commissioner of Internal Revenue.

3. Stipulation of facts filed in said proceeding.

4. Memorandum opinion of the Board of Tax Appeals in said petition.

33 5. Order of redetermination entered in said cause.

6. Petition for review, notice of filing thereof with proof of service.

7. This praecipe.

The foregoing to be prepared, certified and transmitted as required by law and the rules of the United States Circuit Court of Appeals for the Fifth Circuit.

HIRSCH, SMITH & KILPATRICK,
M. E. KILPATRICK,
E. D. SMITH, JR.,
Attorneys for Appellant.

34 CERTIFICATE.

United States Board of Tax Appeals,
Washington.

Donald S. McClain, Petitioner,
vs. Docket No. 92705.
Commissioner of Internal Revenue, Respondent.

I, B. D. GAMBLE, clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages, 1 to 33, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In Testimony Whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 1st day of Dec., 1939.

B. D. GAMBLE,
(Seal) Clerk, United States Board of Tax Appeals.

[fol. 29] That thereafter the following proceedings were had in said cause in the United States Circuit Court of Appeals for the Fifth Circuit, viz.:

ARGUMENT AND SUBMISSION

Extract from the Minutes of March 12th, 1940

No. 9370

DONALD S. McCLAIN,

versus

COMMISSIONER OF INTERNAL REVENUE

On this day this cause was called, and, after argument by M. E. Kilpatrick, Esq., for petitioner, and F. E. Youngman, Esq., Special Assistant to the Attorney General, for respondent, was submitted to the Court.

[fol. 30] IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 9370

DONALD S. McCLAIN, Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE, Respondent

Petition for Review of Decision of United States Board of Tax Appeals (District of Georgia)

OPINION OF THE COURT—Filed March 23, 1940

Before Sibley, Hutcheson and Holmes, Circuit Judges

SIBLEY, Circuit Judge:

Having owned for seven years $15,000 par value of Cameron County Water Improvement District coupon bonds, in 1935 the taxpayer accepted from the District for them $7,476.75, and in his tax return claimed a deduction of $7,523.25 as for a bad debt charged off. The Board of

Tax Appeals upheld the Commissioner in his ruling that the [fol. 31] loss was not a bad debt under Sect. 23 (k) of the Revenue Act of 1934, but fell under a new provision, Sect. 117 (f) of that Act whereby the loss on the bonds was to be treated as a capital loss. This is the sole question here.

Section 117 deals with capital gains and losses, which are "recognized upon the sale or exchange of a capital asset." Prior to 1934, a corporate bond note or other evidence of debt, when it proved bad in whole or in part, could be charged off as a bad debt. Only if sold or exchanged could it be treated as a capital asset. Sect. 117 (f), put into the Revenue Act of 1934, reads thus: "For the purposes of this title amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof) with interest coupons or in registered form, shall be considered as amounts received in exchange therefor." 26 U. S. C. A. Sect. 101 (f). The corporate paper described as registered or bearing coupons is intended for long time investment. The effect of the provision is to make the retirement of it by the maker equivalent for tax purposes to a sale of it to another, and the necessary consequence is that it falls under the capital assets provisions of Sect. 117 (a) and (d), and if it has been held more than a year a loss cannot be taken into account at 100 per cent, and the limitation of capital net losses to $2,000 will apply. Such was the treatment given this loss.

Whether it is correct depends on the meaning of the word "retirement". The Century Dictionary defines "retire" as "to recover, redeem, regain by the payment of a sum of money", and this definition was given judicial approval as applied to a note in Empire Security Co. vs. Berry, 211 Ill. App. 278. Webster's International Dictionary gives, among [fol. 32] other meanings, "to withdraw from circulation, or from the market; to take up and pay, as to retire bonds, to retire a note." The agreed facts about these coupon bonds are these: The District had sought municipal bankruptcy in vain. See Ashton vs. Cameron County District, 298 U. S. 513. It could not collect its taxes and was in default on both principal and interest of its bonds. In order to readjust its indebtedness it applied for a loan to Reconstruction Finance Corporation, which would agree to lend only enough to pay 49.9% of the principal of the bonds. To obtain that all the

bondholders were required to deposit their bonds with a committee with authority "to receive all monies payable to the holders of old securities deposited with it, to surrender deposited securities, and do all other acts necessary to enable the District to effect a reduction in its indebtedness to the extent and in the manner contemplated by this resolution." The bonds of the taxpayer were forwarded to a bank in Texas and on receipt of 49.9% were delivered to the agent of the District to be cancelled. It was understood by the taxpayer and all other bondholders in so surrendering their bonds that the 49.9% received was final, though there was no writing to evidence such agreement between the District and bondholders. We hold that the deposit of the bonds for surrender and their surrender for cancellation on payment by the District of the agreed sum was a retirement of them. If there had been simply a payment of 49.9% on the bonds, they being still held as an obligation good or bad, it would be otherwise. No writing of release was necessary. The surrender and cancellation of the bonds withdrew them from circulation forever, and retired them. What was received must under the statute be treated as the [fol. 33] proceeds of a sale of the bonds. There was no bad debt left to be charged off. The loss on account of the bonds was correctly considered a capital loss.

Affirmed.

[fol. 34] JUDGMENT

Extract From the Minutes of March 23rd, 1940

No. 9370

DONALD S. MCCLAIN

versus

COMMISSIONER OF INTERNAL REVENUE

This cause came on to be heard on the petition of Donald S. McClain for a review of a decision of the United States Board of Tax Appeals, and was argued by counsel;

On consideration whereof, It is now here ordered, adjudged and decreed by this Court, that the decision of the said United States Board of Tax Appeals in this cause be, and the same is hereby, affirmed.

[fol. 35] MOTION AND ORDER STAYING MANDATE—Filed April 1, 1940

IN THE UNITED STATES CIRCUIT COURT OF APPEALS, FIFTH CIRCUIT

No. 9370

DONALD S. McCLAIN, Appellant,

versus

COMMISSIONER OF INTERNAL REVENUE, Respondent

MOTION FOR ORDER WITHHOLDING MANDATE

Now comes Donald S. McClain, appellant in the above entitled cause, and moves this Honorable Court to withhold the issuance of its mandate in the above entitled cause for a period of sixty days from and after the date of the order thereon for the purpose of enabling appellant to prepare and file in the Supreme Court of the United States a petition for certiorari.

(Signed Hirsch, Smith & Kilpatrick, (Signed) E. D. Smith, Jr., Attorneys for Appellant.

[fol. 36] UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH DISTRICT

No. 9370

DONALD S. McCLAIN, Appellant,

versus

COMMISSIONER OF INTERNAL REVENUE, Appellee

On Consideration of the Application of the petitioner in the above numbered and entitled cause for a stay of the mandate of this court therein, to enable petitioner to apply for and to obtain a writ of certiorari from the Supreme Court of the United States, it is Ordered that the issue of the mandate of this court in said cause be and the same is stayed for a period of thirty days; the stay to continue in force until the final disposition of the case by the Supreme Court, provided that within thirty days from the date of this

order there shall be filed with the clerk of this court the certificate of the clerk of the Supreme Court that certiorari petition, and record have been filed, and that due proof of service of notice thereof under Paragraph 3 of Rule 38 of the Supreme Court has been given. It is further ordered that the clerk shall issue the mandate upon the filing of a copy of an order of the Supreme Court denying the writ, or upon the expiration of thirty days from the date of this order, unless the above-mentioned certificate shall be filed with the clerk of this court within that time.

Done at New Orleans, La., this 1st day of April, 1940.

(Signed) Rufus E. Foster, United States Circuit Judge.

[fol. 37] CLERK'S CERTIFICATE

UNITED STATES OF AMERICA:

UNITED STATES CIRCUIT COURT OF APPEALS, FIFTH CIRCUIT

I, Oakley F. Dodd, Clerk of the United States Circuit Court of Appeals for the Fifth Circuit, do hereby certify that the pages numbered from 29 to 36 next preceding this certificate contain full, true and complete copies of all the pleadings, record entries and proceedings, including the opinion of the United States Circuit Court of Appeals for the Fifth Circuit, in a certain cause in said Court, numbered 9370, wherein Donald S. McClain is petitioner, and Commissioner of Internal Revenue is respondent, as full, true and complete as the originals of the same now remain in my office.

I further certify that the pages of the printed record numbered from 1 to 28 are identical with the printed record upon which said cause was heard and decided in the said Circuit Court of Appeals.

In testimony whereof, I hereunto subscribe my name and affix the seal of the said United States Circuit Court of Appeals, at my office in the City of New Orleans, Louisiana, in the Fifth Circuit, this 1st day of April, A. D. 1940.

Oakley F. Dodd, Clerk of the United States Circuit Court of Appeals, Fifth Circuit. (Seal.)

[fol. 38] SUPREME COURT OF THE UNITED STATES

ORDER ALLOWING CERTIORARI—Filed May 20, 1940

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Fifth Circuit is granted, and the case is assigned for argument immediately following No. 895.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.